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Multiple Problems of Multiple Corporations

by Wallace M. Jensen

The Revenue Act of 1964 provided important new rules for the taxation of the income of related corporations. These provisions resulted from the Treasury Department's desire to tax related corporations as though they were one economic unit. As a result of the corporate rate reduction, involving a change in the surtax rate from 22% to 30%, the maximum automatic tax saving for each separate surtax exemption would have increased from \$5,500 to \$7,000 for 1964 and to \$6,500 for 1965. The changes made by Congress with respect to related corporations prevented this increase in the potential tax benefit from being available to multiple corporations and tightened the provisions generally.

The principal changes relating to multiple corporations made by the Revenue Act of 1964 may be summarized as follows:

1. The 2% penalty for filing consolidated returns was eliminated.
2. Members of an affiliated group (parent and subsidiaries) not filing consolidated returns may receive intercorporate dividends tax free under certain circumstances.
3. Members of a controlled group of corporations are limited to one surtax exemption unless they elect to utilize multiple surtax exemptions and pay a penalty tax.
4. Section 1551, which disallows the surtax exemption where one corporation has transferred property to a controlled corporation, was broadened and tightened up.

Limitations on Multiple Corporations Under Prior Law:

Prior to 1964 the statutory provisions available to the Government as a weapon against the use of multiple corporate surtax exemptions may be summarized as follows:

1. Since 1943, Section 269 has covered the acquisition of direct or indirect control of a corporation where the principal purpose is avoidance of tax by securing the benefit of a multiple exemption. Although it did not seem to be clearly intended when the statute was enacted, the Treasury has been supported in applying Section 269 to the division of a corporation into two or more corporations for the purpose of obtaining additional surtax exemptions.[1]
2. Since 1951, Section 1551 has specifically denied the surtax exemption to the transferee corporation if property, other than money, was transferred by a corporation to a controlled corporation unless the securing of the exemption was not a major purpose of the transfer.
3. Section 482 gives the Commissioner power to allocate deductions, credits, or allowances between affiliated corporations and has been used by the Internal Revenue Service to reallocate income between controlled corporations.

In applying these sections, there has been considerable difficulty in distinguishing between bona fide business purpose and tax avoidance motive and, as a result, there has been much controversy and litigation in this area.

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Changes Proposed in President's 1963 Tax Message:

In his 1963 tax message to Congress, the President proposed to eliminate the advantage of multiple surtax exemptions available to large enterprises operating through a chain of separately incorporated units. In further explaining the recommendation, the Secretary of the Treasury pointed out that the surtax exemption was intended as an incentive for small business, but it had been converted into a large bonus for middle and big business. He contended that the mere fact that there were valid business reasons for many of the multiple corporate structures did not justify treating each corporate unit in the group as if it were an independently controlled small business. He also pointed out that in some situations the statute even provided an incentive for uneconomic corporate arrangements and deliberate abuse through proliferation of corporate units.

Accordingly, the President recommended that provisions be adopted to limit related corporations subject to 80% common ownership and control to a single surtax exemption. Related corporations would include not only 80% owned corporations which are subsidiaries of the same corporate parent (parent-subsidiary corporations) but also brother-sister corporations which were 80% owned by the same five or fewer individuals. Also included would be corporations which were commonly controlled subsidiaries, namely, 80% owned by five or fewer corporations. The President proposed that denial of the multiple surtax exemption benefits should be made effective gradually over a five-year transition period in order to prevent any abrupt financial impact on multiple corporate groups.

Congress accepted only part of the President's program, apparently recognizing the legitimate business reasons for multiple corporations. As finally enacted, the multiple corporation provisions are a complicated structure that provide some flexibility to corporate groups.

Amendments to Section 1551:

Under prior law, Section 1551 provided that if a corporation transferred property (other than money) to another corporation created to acquire the property or if the transferee corporation was not actively engaged in business at the time of the transfer, and if there was common control of the two corporations, the transferee corporation was not allowed a surtax exemption unless it established by the clear preponderance of the evidence that the securing of the exemption was not a *major* purpose of the transfer. The Revenue Act of 1964 made two important changes in this provision.[2]

In the first place the existing law applied only to *direct* transfers of property other than money. Under the 1964 amendment, Section 1551 would also apply to indirect transfers of property. For example, if Corporation X organizes Corporation Y as a wholly-owned subsidiary and transfers cash to Corporation Y, and if Corporation Y then uses such cash to purchase machinery from Corporation X, then Corporation X would be considered to have made an indirect transfer of property to Corporation Y.

The second change extends the application of Section

1551 to transfers of property (other than money) by an individual to a corporation which he and not more than four other individuals control. For the purpose of determining whether the transferor is considered to be in control of the transferee corporation, the individual who makes the transfer, together with no more than four other individuals, must own at least 80% of the value or voting power of the stock in two or more corporations, one of which is the transferee corporation; and the same individuals must own more than 50% in each corporation by taking into account identical stockholdings in the corporations. Constructive ownership rules of the new Section 1563(e) apply. The Statute does not define the meaning of identical holdings, but the legislative history indicates that it covers the aggregate of the lowest percentage of ownership in each of the several corporations. For instance, if Corporation X is owned 55% by A and 45% by B and if Corporation Y is owned 45% by A and 55% by B, they are both more than 80% owned by five or fewer individuals. The identical holdings are considered to be 45% by A and 45% by B, or a total of 90%.

General Rule Limiting Multiple Surtax Exemptions:

The Revenue Act of 1964 added a new Section 1561 to the Code which provides a general rule limiting a controlled group to one surtax exemption. This is an automatic denial of multiple surtax exemptions, irrespective of whether there is any acquisition of control under Section 269 or transfer of property under Section 1551.

The limitation applies to each member of a controlled group on any December 31. A single $25,000 surtax exemption is to be allocated equally to each corporation in the group unless all of the corporations which are members of the group consent to a different apportionment under regulations to be issued. Under temporary regulations[3] the apportionment plan for a group determined as of December 31, 1963, must provide for a fixed dollar apportionment to the corporations and must be consented to by all of them except wholly-owned subsidiaries. The consent statement may incorporate the consents of several corporations and must be filed with the timely return of that corporation, which return is the last to be due, or by June 30, 1964, if that date is later. An apportionment plan adopted pursuant to the temporary regulations cannot be amended or revoked after such last day, unless an election of multiple surtax exemptions with respect to December 31, 1963, is made under Section 1562(a)(1). Such an apportionment plan shall be valid only for the taxable year of each member of the group which year includes December 31, 1963. If an apportionment plan is desired with respect to any succeeding December 31, new consents will be required.

Although the new Section 1561 is applicable to taxable years ending after December 31, 1963, transitional rules contained in temporary regulations[4] clarify the problem of a controlled group of corporations, one or more of which have fiscal years ending in 1964. For this purpose, corporations having a taxable year ended on December 31, 1963, are excluded from the group.

For example, assume a controlled group consists of Corporation A, on a calendar year, and Corporation B, on a fiscal year ended March 31, and that the group was the same on both December 31, 1963, and December 31, 1964. B's exemption for its fiscal year ended March 31, 1964, is the full $25,000 since A is disregarded for 1963. A's exemption for the calendar year 1964 is $12,500 and B's exemption for its fiscal year ending March 31, 1965, is also $12,500, unless they both consent to a different apportionment.

Special rules are also provided for a corporation which has a short taxable year which does not include a December 31, but which is a member of a controlled group on the last day of its short taxable year. In such case its exemption is $25,000 divided by the number of corporations in the group. No allocation by consent is permitted in this case.

Accordingly, the basic rule is that all of the corporations in a controlled group are limited to only a portion of a single surtax exemption, unless they elect multiple surtax exemptions and pay a penalty tax.

Privilege of Electing Multiple Surtax Exemptions:

Section 1562, added by the Revenue Act of 1964, provides an alternative choice for multiple corporations. In lieu of the general rule limiting a controlled group of corporations to one surtax exemption, each corporation in the group may elect to use its full exemption. If the election is made, each corporation is subject to an automatic additional tax of 6% on the first $25,000 of taxable income of each corporation in the group. Thus, the maximum tax saving per corporation is reduced from $7,000 to $5,500 for 1964 and from $6,500 to $5,000 for 1965 and subsequent years. In addition, corporations that elect separate surtax exemptions are not entitled to the 100% intercorporate dividends received deduction discussed later in this paper.

The election to use multiple surtax exemptions is to be made under regulations. A consent must be filed by all corporations which were members of the group on the specified December 31, as well as by all other corporations which became members of the group after the applicable December 31 and prior to the filing of the election.

The election may be made at any time within three years after the original due date of the return for the member whose taxable year first ends on and after the specified December 31. Once it is filed, the election remains effective for the group and any "successor group" (as determined by the Commissioner) for each succeeding taxable year until terminated.

Termination of the election may occur by the filing of a consent to termination by all of the corporations covered by the election, by the filing by a new member of the group of a refusal to consent to the election, by the filing of a consolidated return by any member, or by the group's ceasing to exist. Consent to termination may be filed at any time within three years of the specified December 31 with respect to which it is effective.

It should be noted that, once the election of multiple surtax exemptions has been made, the election continues in effect until terminated. Even if a new member joins the group, the election is effective unless the new member takes the positive action of filing a refusal to consent. This is the reverse of Subchapter S where the prompt timely filing of a consent by a new stockholder is required.

The three-year period within which the original election may be made presents an opportunity for a controlled group to wait until it is certain that the election would produce savings in tax before making the election. If the election of multiple surtax exemptions under 1562 is deferred, the members of the group should consider making the election under Section 1561, apportioning the single surtax exemption as a protection in the event that the election under Section 1562 is not made. The three-year period for filing a termination also presents the group with the possible advantage of hindsight. It is not clear, however, whether the filing of a termination is limited to a taxable year subsequent to the year of original election or whether it could, in effect, revoke the original election for the first taxable year to which that election applied.

If the election of multiple surtax exemptions is terminated, a new election may not be made by the group or its successor for five years. The statute of limitations for assessment and for refund of tax, to the extent attributable to an election or termination under Section 1562, is automatically extended until one year after the consent to election or termination is filed.

Elimination of 2% Additional Surtax on Consolidated Returns:

In view of the statutory provisions designed to limit multiple surtax exemptions and in order to promote the filing of consolidated returns by affiliated groups, the Revenue Act of 1964 amended Section 1503(a) to eliminate the 2% additional surtax on the consolidated net income of affiliated corporation groups filing consolidated returns. This change is effective for taxable years beginning after December 31, 1963.

Election of 100% Dividends Received Deduction For Affiliated Groups:

The Revenue Act of 1964 added a new provision[5] under which a parent-subsidiary affiliated group may elect a 100% dividends received deduction with respect to any dividends paid out of earnings and profits for a taxable year ending after December 31, 1963, by a corporation which was a member of the affiliated group. For this purpose the term "affiliated group" has the same meaning as for consolidated return requirements except that a domestic insurance company may be included. The essential requirement is ownership of at least 80% of voting power and of value.

Dividends will qualify for the 100% deduction only if both the recipient corporation and the distributing corporation are members of the same affiliated group for each day of the distributing corporation's taxable year from which the earnings and profits are distributed and also at the close of the day in which the dividend is received. Furthermore, qualifying dividends are limited to those which are distributed from earnings and profits of a taxable year ending after December 31, 1963, and for which an election of multiple surtax exemptions (under Section 1562) is not effective. In addition, the affiliated group must have made an election which is effective for the taxable years of the members of the group which include the day the dividend is received.

The election of the 100% dividends received deduction shall be made for the affiliated group by the common parent corporation and consented to by all members of the group at such time and in such manner as prescribed by regulations. Under preliminary regulations[6] the election statement is to be filed with the parent's return or by June 10, 1964, if that is later. A wholly-owned subsidiary is automatically deemed to consent to the election, but such subsidiary must include a statement of this fact in its first return filed under the election. A consent statement for each other subsidiary must be filed with the parent's election, although multiple consents may be incorporated in a single statement.

As a condition for the election of the 100% dividends received deduction, no member of the group may elect to claim mutiple surtax exemptions for the same taxable year. In addition, all corporations in the group must either deduct foreign taxes or take credit for them and, if credit is taken, all must use either the "per country" limitation or the "overall" limitation. In addition, members of the affiliated group are to be treated as one corporation for the purpose of the $100,000,000 minimum accumulated earnings credit, the $100,000 exemption for estimated tax filing requirements, the $100,000 and $400,000 limitations for exploration expense, and the $25,000 limitation on small business deduction of life insurance companies. The right to elect the 100% dividends received deduction is effective with respect to dividends received in taxable years ending after December 31, 1963.

Termination of the election occurs when the parent files a termination of election and is effective for the specified taxable year of the parent corporation and for the taxable years of the other corporations in the group which include the last day of the parent's taxable year. All of the other corporations in the group must consent to the termination. Termination may also be effected if a new member of the group files a statement that it does not consent to the original election. The time and manner of filing the termination of election are to be prescribed by regulations.

What Is a Controlled Group of Corporations?:

The new statutory provisions contain definitions of the term "controlled group of corporations" for the purpose of Sections 1561 and 1562, both of which relate to multiple surtax exemptions. A controlled group may consist of either a parent-subsidiary group, a brother-sister group, or a combined group which may result when a common parent is also part of a brother-sister group. "Control" generally means 80% stock ownership with the application of some special rules and with limited constructive ownership.

Inasmuch as the composition of the controlled group is determined every December 31, adjustment is to be made for corporations joining or leaving the group prior to that date. For instance, a corporation is excluded from the group even though it was actually a member on December 31 if it was a member for less than one half of the number of days within the taxable year which precede that December 31. Also, a corporation is included even if it is no longer in the group on December 31 if it was a member during the year for one half or more of the number of days within the taxable year which precede that December 31. Certain corporations are also excluded, such as corporations exempt from tax, foreign corporations not engaged in trade or business in the United States, and certain insurance companies. There is also a special exclusion for corporations operating under a franchise to distribute products of another member of the group where the parent is required to sell the stock of that corporation to employees of the distributor corporation.

Control:

For the purpose of determining control, the basic test is the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote *or* at least 80% of the total value of shares of all classes of stock.

For the purpose of applying the 80% test, certain stock is excluded. Treasury stock and nonvoting stock which is limited and preferred as to dividends are to be disregarded. In a parent-subsidiary controlled group, if a parent owns 50% or more of the subsidiary, the 80% control test may be met by not counting the stock owned by the following related persons:

1. An individual who is a 5% stockholder of the parent.
2. An officer of the parent corporation.
3. An exempt employees' trust formed by either the parent or the subsidiary.
4. An employee of the subsidiary if his stock is subject to substantial restrictions on disposition which run in favor of the parent or the subsidiary.

In the case of a brother-sister corporation group, if the corporations are at least 50% owned by a controlling individual, trust, or estate, the equivalent of the special rules 3 and 4 above also apply.

Special rules of constructive ownership also apply in determining control under the 80% test. For parent-subsidiary groups, a corporation is considered to own stock subject to its purchase option. For brother-sister groups, stock subject to option is considered to be owned by the optionee. An individual is also considered to own his proportionate share of stock owned by a partnership, a corporation, and an estate or trust if he has a 5% or more interest therein. His 5% (or more) interest in the case of a partnership depends upon his interest in either profits or capital, whichever is greater. In the case of a corporation, it is the value of his proportion of ownership to the value of all the stock in the corporation. In the case of an estate or trust (except an exempt employees' trust), stock is attributed to a beneficiary who has an actuarial interest of at least 5%, assuming maximum exercise of discretion by the fiduciary in favor of such beneficiary. In each case the attribution is only to the extent of his interest.

In the case of an individual, stock owned by his minor child is attributed to the parent and the parent's stock is deemed to be owned by the minor child. Stock owned by a parent, grandparent, grandchild, or adult child is deemed to be owned by an individual only if the individual otherwise owns more than 50% of voting power or of the value of the stock. In other words, if a parent and his adult son each own 50% of the stock of two corporations it would not qualify as control. If, however, the parent owned 55% and the son owned 45%, it does qualify as control.

An individual is also considered to own stock owned by his spouse unless he does not directly own any stock in the corporation and if he is not a director or employee of the corporation and does not participate in its management and if not over 50% of the corporation's income consists of royalties, dividends, rents, interest, and annuities.

The attribution rules are extremely complex and differ in many respects from those in Section 318 of the Code. For instance, there is no back attribution from an individual to a partnership, corporation, estate, or trust. There is also a more limited rule of attribution to a spouse.

Problems of Practical Application:

It is likely that most controlled corporation groups will elect multiple surtax exemptions and pay the additional 6% tax. Generally this will be advantageous in the case of brother-sister corporations having a combined taxable income of more than $31,818 in 1964 and $32,500 after 1964. There are exceptions to this test. If one corporation has a loss or only a very small profit, the combined tax may be greater than if all corporations had a small profit.

If the controlled group consists of two brother-sister corporations, A and B, and if Corporation A has elected to be taxed under Subchapter S, then neither Section 1561 nor Section 1562 should apply to Corporation B. Likewise, if three or more controlled corporations elect multiple surtax exemptions and in a subsequent year one of such corporations elects Subchapter S, that should not terminate the multiple surtax exemption election as to the other corporations in the group.

The 100% dividends received deduction election may be more attractive to some parent-subsidiary groups. While the elimination of the 2% penalty tax on consolidated returns may cause many of such groups to file a consolidated return, there are still some good business reasons for not doing so, particularly where the corporations have different natural fiscal years and where it would be undesirable to use the same accounting method for all groups. The 100% dividends received deduction election will permit the passing through to the parent corporation of the earnings for taxable years ending after December 31, 1963. It would not permit passing through pre-1964 accumulated earnings. In such a case a consolidated return may be more attractive.

As previously noted, the definition of an affiliated group for the purpose of the 100% dividends received deduction is not the same as the definition of a controlled group of corporations for multiple surtax exemption purposes. For example, the parent corporation may own 80% of the voting power but not 80% of the value of the stock of the subsidiary, and thus it would not qualify under Section 243 but would qualify under Sections 1561 and 1562.

The purchaser of 80% control of a corporation is now faced with the necessity of ascertaining whether that corporation was a member of a controlled group of corporations and, if so, what election was in effect, as it is possible that the corporation would not be entitled to any surtax exemption for the year of purchase. This is more important in the case of smaller corporations where the resulting effect on tax liability would be relatively large.

Conclusion:

The use of multiple corporations will still be advantageous as there will be substantial savings after electing separate surtax exemptions and paying the 6% penalty tax. It will still be necessary to show that the creation of separate corporations was motivated by good business reasons. Otherwise, the Commissioner can use the weapon of disallowing the surtax exemption where avoidance of tax was the major purpose for the separate corporate entities. However, as a result of the changes made by the Revenue Act of 1964, the taxpayer may now contend that Congress intended the new rules of electing the 6% penalty tax to take precedence over the old general rules of complete disallowance. In any event, the tax practitioner must be continually alert to the multiple corporate problem.

[1] *James Realty Co.* v. *U.S.* 280 F(2d) 394 (8th Cir. 1960), *Coastal Oil Storage Co.* v. *Comm.* 242 F(2d) 396 (4th Cir. 1957).

[2] Section 235(b) of the Revenue Act of 1964, amending Section 1551 of the Internal Revenue Code.

[3] Temp. Reg., Sec. 19.5-1(b), added by T.D. 6733 (May 13, 1964).